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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 136

THE BADGER OIL COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Badger Oil Company, a corporation organized under the laws of the State of Texas, prays this Court for the issuance of a writ of certiorari to review the final judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered on the 8th day of April, A. D. 1941, affirming a decision of the United States Board of Tax Appeals.

Statement of the Matter Involved.

The matter involved herein is a question of the interpretation and application of the Revenue Laws of the United States and the Regulations thereunder with respect to the allowance of percentage depletion on the consideration of $305,000.00 received for the assignment of an oil and gas lease to the International Petroleum Corporation in 1935.

Petitioner in 1926 acquired an oil and gas lease and drilled and acquired thereon seven producing oil wells (R. 64 and R. 74). Subsequently, on April 17, 1934, it acquired from the land owners, the Lewises, the fee title to their 2,947.8 acre ranch, in Hutchinson County, Texas (R. 67), under which the petitioner's 1,321 acre oil and gas lease was located, together with their two-thirds remaining royalty or mineral interest in such lands which had never been separated from the fee (R. 67). In February, 1935, while the owner of the lease, the fee, and all the mineral interest in the oil in place, except the outstanding one-third royalty interest, the petitioner transferred by assignment its 1,321 acre oil and gas lease and executed a new lease to an additional 160 acres which had heretofore reverted to it (R. 65), receiving therefor a consideration of $305,000.00 in cash in 1935, exclusive of the cash consideration received for the sale of the personal property located on the leasehold estate (R. 65). The directors of petitioner were influenced in making the sale by their knowledge that the International Petroleum Corporation intended as soon as it became the owner to begin a large development of the property (R. 60-62). This intention was carried out and at the time of the hearing the purchaser had completed forty-two wells and had one well drilling (R. 61). The petitioner

would not have sold for the amount received if it had not anticipated a large return from its retained royalty interest (R. 61). Royalty oil and gas received from February 1, 1935, to November 1, 1939, amounted to $97,858.64 (R. 66).

Petitioner sought to deduct percentage depletion on the cash consideration of $305,000.00 thus received (R. 79). The Commissioner of Internal Revenue disallowed depletion on the cash consideration which had been deducted by petitioner on its 1935 income tax return and assessed a deficiency in income tax of $9,860.32 and an Excess Profits Tax of $3,585.57 (R. 13), the petitioner petitioned the Board of Tax Appeals for review (R. 41), the respondent answered (R. 17), hearing was had at Dallas, Texas (R. 1), and rehearing (R. 2), and opinion and findings of fact rendered by the Board of Tax Appeals (R. 32), affirming the Commissioner's disallowance of depletion, and petitioner filed its petition for review by the Honorable United States Circuit Court of Appeals for the Fifth Circuit (R. 41), and the Honorable Circuit Court of Appeals entered its decision affirming the decision of the Board of Tax Appeals on the 8th day of April, 1941 (R. 149).

The petitioner duly filed on the 28th day of April, 1941, within 21 days from such decision by the Circuit Court of Appeals, its petition for a rehearing by the Circuit Court of Appeals (R. 150), which petition was denied (R. 157), and petitioner filed its motion to stay mandate on the 19th day of May, 1941, and within ten days from the overruling of its petition for rehearing (R. 157), and the Honorable United States Circuit Court of Appeals for the Fifth Circuit issued its order staying mandate for thirty days from May 19, 1941, the date of its order (R. 159).

Basis of Jurisdiction.

The judgment sought to be reviewed is the judgment of the United States Circuit Court of Appeals for the Fifth Circuit rendered on the 8th day of April, 1941 (R. 149), affirming a judgment of the Board of Tax Appeals on a matter involving the revenue laws of the United States. The nature of the case is one involving the question whether petitioner is entitled to percentage depletion on a cash consideration received from the transfer of a part of its interest in oil in place and is explained in the preceding statement.

The opinion of the United States Circuit Court of Appeals for the Fifth Circuit filed on the 8th day of April, 1941 (R. 143), reflects the decision of said court to be that, although the taxpayer, being the fee owner of the land and owning a reversionary interest in the 7/8ths operating interest, and owning also the lease, retained an economic interest in the oil reserve, by virtue of the transaction, and that even though taxpayer after selling its lease, still had an interest in the oil reserve as successor in title of the lessor and as part owner of the reversion, it was nevertheless not entitled to deplete the cash consideration as a bonus as upon a lease, but is relegated to the position of a mere lessee selling its lease and reserving no interest in the property, although by privity of estate existing by virtue of the assignment of the lease, the assignee was obligated under the lease to pay as royalty a portion of all oil and gas produced to petitioner, assignee of lessor, for the life of the lease. Petition for rehearing was filed on the 28th day of April, 1941 (R. 150), and same was denied on the 10th day of May, 1941 (R. 157), and petition for writ of certiorari is presented herein on the 6th day of June, 1941.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as Amended by the Act of

February 13, 1925, C. 229, Section 1, 43 Stat. 938 (28 U. S. C. A. 347) (8 F. C. A. Title 28, Section 347), and under Section 641 (a) of the Internal Revenue Code (Feb. 26, 1926, c. 27, Sec. 1003 (a), 44 Stat. 110; June 7, 1934, c. 426, 48 St. 926) (26 U. S. C. A. Section 1141) (6 F. C. A. Section 641).

Question Presented.

The primary question presented is:

> Whether petitioner had and retained an interest, *i. e.*, a capital investment in oil and gas in place so as to entitle it to the percentage depletion allowance under Section 114 (b) 3 and 4 and Section 23 (m) of the Revenue Act of 1934 on $302,350.00 of the consideration of $305,000.00 received for the leasing transaction.

Reasons for Allowance of the Writ.

Reason 1.

The judgment and decision of the Circuit Court of Appeals that petitioner, "After selling outright for money its lease interest, still had an interest in the oil reserve as the successor in the title of lessor, but that is not the same thing as retaining a royalty in the transfer. His interest stood unmerged. He sold his lease interest without any reservation," when petitioner was the owner of all interests in the oil and gas in place save and except an outstanding one-third interest in the royalty and reversion, has decided a Federal question in a way probably in conflict with applicable decisions of this court, in *Palmer* v. *Bender*, 287 U. S. 551; *Wm. E. Herring* v. *Commissioner of Internal Revenue*, 293 U. S. 222; *Thomas* v. *Perkins*, 301 U. S. 655, *Guy T. Helvering, Commissioner*, v. *Bankline Oil Company*, 303 U. S. 362, and *Guy T. Helvering* v. *Thomas A. O'Donnell*, 303 U. S. 370.

The Circuit Court of Appeals bases its decision on *Commissioner* v. *Fleming,* 82 F. (2d) 324 and *Laird* v. *Commissioner,* 97 F. (2d) 730, also *Hammonds* v. *Commissioner,* 106 F. (2d) 420, all of which involve cases where the taxpayer had only a working interest in the property to start with and sold all of such interest. The royalty retained by petitioner in this case and the bonus received for the transfer is analogous to the overriding royalty retained by the Smitherman partnership in *Palmer* v. *Bender,* out of their working interest lease.

The Supreme Court in its decision in *Palmer* v. *Bender* calls attention to the fact that "The Government rests its case on this conclusion (the conclusion referred to being that the instruments were assignments of leases or sales of the leases for the stipulated consideration of bonus paid and royalties to be received). It concedes that if any *reversionary interest,* according to the common law, however small has been retained in the leased land by the two partnerships, the petitioner is entitled to the depletion allowances claimed, * * *."

In *Bankline Oil Company, Petitioner* v. *Commissioner of Internal Revenue, Respondent* (33 B. T. A. 910), the decision of the Board of Tax Appeals was reversed by the Ninth Circuit Court of Appeals (90 F. (2d) 899) and because of an asserted conflict with the principles applicable under decisions of the Supreme Court certiorari was granted there where the question was whether the holder of a favorable contract to purchase wet gas at the well had the economic interest necessary to entitle him to depletion; in *Helvering* v. *O'Donnell,* 303 U. S. 370, and *Helvering* v. *Elbe Oil Co.,* 303 U. S. 372, where the question was whether a share in the net profits from development and operation was such an interest was the point upon which certiorari was granted. In all the cases just named, a new situation

under the peculiar circumstances of each case as provided by statute, presented the question whether a depletable economic interest had been retained. Petitioner's case now presents an entirely new situation for application of the depletion statutes. Petitioner probably had such required retained interest. If it did, the Circuit Court erred in its decision, and such decision conflicts with applicable decision of the Court. So, there is probability of conflict with the applicable decisions of the Supreme Court justifying issuance of the writ of certiorari so that the question may be settled.

The Supreme Court has held that the language of the Statute is broad enough to permit a depletion allowance in every case where a taxpayer had acquired, by investment, an interest in the oil in place, and acquired, by legal relation, income derived from the extraction of oil, to which the taxpayer must look for the return of his capital. The Supreme Court has also stated that the right to depletion allowance does not depend upon the retention of ownership or special form of legal interest in the mineral content of the land, but upon his right to share in the oil produced. Thus, if he has an economical interest in the oil in place, he is entitled to the depletion allowance (*Palmer* v. *Bender, supra*).

Reason 2.

The Circuit Court of Appeals, in holding as it did in this case that petitioner was not entitled to percentage depletion on a cash payment received for the assignment of a part of petitioner's interest in the oil reserve, basing its decision as it did on the fact that the entire title to the minerals never vested in petitioner so that petitioner could not claim to hold a full lessor's interest, probably conflicts with applicable decisions of the Supreme Court, particularly with the decision in *Palmer* v. *Bender,* 287 U. S. 551,

53 S. Ct. 225, under the holding therein "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired by investment, any interest in the oil in place, and secures by any form of legal relationship income derived from the extraction of the oil, to which he must look for a return of his capital," and the decision in *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, under the holding therein that the allowance for depletion is not made dependent upon the particular form of the taxpayer's interest in the property to be depleted.

For convenience, we may break up petitioner's interests, at the time of the transaction, into such elements as royalty rights, or as to the right to demand and receive payment of rentals in lieu of drilling operations, or as to its inchoate right to the reversion of the working interest transferred to its assignee, all of which interests petitioner had in the property, but actually all such elements at the time of the transfer to International Petroleum Corporation were, as to ownership, in petitioner to form "all the right, title, interest and claim" which petitioner had in and to the property, and represented petitioner's capital investment therein, and the Circuit Court held that petitioner "owning reversionary interests and accompanying royalty, and owning also this lease, chose to retain the former and sell the latter. It retained as vendee of the lessors an economic interest in the oil reserve;" and, as said in *Alexander* v. *Continental Petroleum Co.*, 63 F. (2d) 927: "We agree the transaction was a sale of leases. But it was not an end of the plaintiffs interest in the production of oil."

The record as to the transaction itself discloses that International Petroleum Corp., as lessee's assignee, was bound by acceptance of the assignment to pay to petitioner, lessor's assignee, the royalty provided in the lease out of all oil produced from the lease by International Petroleum

Corporation, *Leonard* v. *Prater*, Com. App. 1931, 36 S. W. (2d) 216, 217, 86 A. L. R. 499. The legal relationship which secured income from the production of oil was thus secured by the petitioner by virtue of the transaction, which this Court in *Palmer* v. *Bender, supra*, said the statute provided for.

The decision of the Circuit Court also probably conflicts with the applicable principles of decision of the Supreme Court in the following cases: *Works* v. *United States ex rel. Mosier*, 261 U. S. 252; *Murphy Oil Co.* v. *Burnett*, 287 U. S. 299; *Palmer* v. *Bender*, 287 U. S. 551; *Wm. E. Herring* v. *Commissioner of Internal Revenue*, 293 U. S. 222; *Thomas* v. *Perkins*, 301 U. S. 655; *Guy T. Helvering, Commissioner*, v. *Bankline Oil Company*, 303 U. S. 362; *Guy T. Helvering* v. *Thomas A. O'Donnell*, 303 U. S. 370; *Anderson-Pritchard* v. *Helvering*, 310 U. S. 404, 60 S. Ct. 952. It also conflicts with the decision by our Texas Courts in *Jensen* v. *Wilkinson et al.*, 133 S. W. (2nd) 982, on the question of retained taxable interest, that court holding a reversionary interest in a working interest to be a taxable interest in land.

Reason 3.

The judgment and decision of the Circuit Court of Appeals that "none of that royalty was paid in advance by International Petroleum Corporation in this purchase. It all remained to be paid. There is no room to say that the money in this transaction was paid as advance royalty and hence is depletable income arising from operation of oil wells," when petitioner, before making the lease transaction, was the land owner, the oil developer and operator and the owner of the royalty and reversion rights, all of the possible interests being merged in one common ownership, except that of the outstanding one-third royalty and one-third reversion, and petitioner would not have sold for the

$305,000.00 consideration received if it had not anticipated a large return from its retained royalty interest, has decided a Federal question in a way probably in conflict with applicable decisions of this Court in *Works* v. *United States, ex rel. Mosier,* 261 U. S. 252; *Murphy Oil Company* v. *Burnett,* 287 U. S. 299; *Palmer* v. *Bender,* 287 U. S. 551; and *Wm. E. Herring* v. *Commissioner of Internal Revenue,* 293 U. S. 222. The royalty rate was already fixed in the instrument transferred and the cash consideration, a variable one depending upon the desirability of the privilege of entering upon the land for development purposes, paid by the International Petroleum Corporation, secured for that company desirable oil property and secured for the petitioner the just value of the use of its property, which the fixing of royalties by the Lewises in the original oil and gas lease, in advance, was not adapted to give, and as said in *Palmer* v. *Bender, supra.*

"Thus throughout their changing relationships * * * the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees were entitled to share in the oil produced. Production and sale of the oil produced would result in its depletion and also in a return of capital investment to the parties according to their respective interests."

Reason 4.

The decision and judgment of the Circuit Court of Appeals in refusing allowance of depletion to petitioner having a capital investment in the oil and gas in place constantly depleted by production under the lease assigned, the assignee thereof being contractually bound by acceptance of the assignment to account for a share of production, the

decision and judgment of the Circuit Court of Appeals being that such a transaction was a sale of a lease without any reservation and the consideration received was purchase money and that the taxpayer, after selling outright its lease interest, still had an interest in the oil reserve as successor in title of the lessor, but such a transaction was not the same thing as retaining a royalty in the transfer, has decided an important question of Federal law which has not been but should be settled by this Court. Many cases have decided that assignors of leases who retain no interest in the oil in place cannot deplete the cash received for the transfer as a bonus or advance royalty because of outright sale of all interests in the oil reserve, but no case has been found deciding whether one who has operated a lease as a lessee for a number of years, producing oil and gas, then acquires the fee and royalty together with the reversion all still attached to the fee, except as to a small outstanding royalty interest in third parties, and, who later assigns only the lease, has retained such an interest as to entitle him to depletion under an assignment of lease, the acceptance of which obligated the assignee to account to assignor for a portion of the production from the property throughout the life of the lease. The principles involved in this case will find frequent application in connection with the taxation of persons and corporations engaged in the oil industry. The question is one of general importance and to deny the taxpayer the right to deduct percentage depletion where he, as owner of the working interest subsequently acquires a fee and then disposes of the working interest, to secure income from operation of his land for oil and gas by another, leads to inconsistency in the application of the Internal Revenue laws.

Reason 5.

The decision and judgment of the Circuit Court of Appeals in the case has decided an important question of local law in a way probably in conflict with applicable local decision, in that the Circuit Court has failed to recognize and give effect to the rule of property established by the decision of the Courts of Texas holding the reversionary interest in the 7/8ths leasehold under oil and gas leases to be taxable interests in land, and when petitioner in this case transferred the 7/8ths operating interest, it retained the reversion therein, and had and retained a taxable interest in the very thing transferred.

Conclusion.

Wherefore, for the reasons herein advanced, it is respectfully submitted that the Supreme Court of the United States should exercise its jurisdiction to review by writ of certiorari the judgment of the Circuit Court of Appeals to the end that an important question of Federal Law involving the construction of a Federal statute and regulations thereunder relating to allowance of percentage depletion be settled, and an end be put to the probable conflict in the decisions of Circuit Courts of Appeals with applicable decisions of the Supreme Court.

Respectfully submitted,

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